APPENDIX

JLKichline
July 16, 1984

FOMC CHART SHOW -- INTRODUCTION

During our presentation this afternoon we will be referring to the package of charts distributed to you. The first chart displays the principal assumptions that underlie the staff's economic and financial forecast. The monetary growth assumptions are essentially the same as we have used in forecasts prepared earlier this year. Given the staff's economic outlook, it seems likely that the monetary assumptions are consistent with a little further rise of short-term interest rates and maintenance of generally high rate levels throughout the forecast period ending in 1985. For fiscal policy, we are assuming deficit-reducing actions of around $25 billion for fiscal year 1985, which is consistent with the tax actions recently passed by the Congress and the expected further actions on spending bills still in the Congress. We also continue to assume that the dollar will decline over the forecast period although the 15 percent drop is from a higher level than we had been expecting.

The next chart provides some additional information on the federal budget. Outlay growth projected by the staff continues to be large, with particularly big increases for defense and interest. The budget deficit is expected to narrow somewhat in fiscal 1984, but given the policy assumed the deficit will be on the rise again in fiscal 1985. The Administration has not yet completed work on the budget update, although they are expected to show deficit figures below those of the staff.

The structural deficit, measured at a 6 percent unemployment rate, increases considerably in both 1984 and 1985. By fiscal year 1985 high rates of resource utilization in the economy translate into only a small cyclical component remaining in the budget. The bottom panel indicates outlays as a percent of GNP are projected at about 24 percent, around 5 percentage points above receipts. Current policy does not make any appreciable dent in the gap, and the budget posture will continue to exert a powerful influence on economic and financial developments.

Mr. Zeisel will discuss the recent and prospective domestic nonfinancial situation.

Joseph S. Zeisel
July 16, 1984

FOMC CHART SHOW -- NONFINANCIAL DEVELOPMENTS

The economy has been showing impressive strength at a stage of the business cycle when growth more frequently then not has decelerated considerably. As indicated in the top panel of the next chart, real GNP rose at a 9-3/4 percent rate in the first quarter, and we estimate that second quarter growth was 6-3/4 percent, about a percentage point more than the Commerce flash. The slowing in the second quarter reflected a lower rate of nonfarm inventory investment after a surge in the first quarter. As indicated in the lower panel, growth of real private domestic final purchases--i.e., consumption plus fixed investment--in the second quarter apparently equalled the extremely strong 8 percent plus first quarter pace.

Nevertheless, there have been indications recently of decelerating activity here and there in the economy, as the next chart indicates. Not surprisingly, housing, which is particularly sensitive to the cost of credit, has shown signs of weakening after the recent runup in interest rates. Starts on balance have trended down since early this year and at a 1-3/4 million annual rate in May were 10 percent below the average of the first four months. In manufacturing, as indicated in the right-hand panel, the rise in jobs has moderated from late last year. Moreover, growth of industrial production has slowed. In the past two months industrial activity has increased about half percent a month, following gains averaging about 1 percent earlier this year. Recently, as shown in the lower panels, strength has been concentrated in the business and defense and space equipment sectors, while production of durable consumer goods and construction supplies has levelled off.

As the next chart indicates, we are projecting a substantial moderation of GNP growth in coming months. We anticipate that consumer spending will remain fairly robust in the near term on the basis of recent gains in employment and income, and indicators of capital outlays are quite strong. Thus, GNP is projected to advance at a still-relatively-brisk 5-1/4 percent annual rate this quarter. But we expect that activity will be increasingly constrained by financial conditions implied by monetary assumptions and the expected increase in inflation. On balance, we are projecting a rate of real GNP growth of about 4-1/2 percent in the second half of this year and about 2-3/4 percent in 1985.

The bottom panel presents a disaggregated view of GNP gains by half years in 1984 and 1985. As is evident, the progressive slowing in growth of private domestic final purchases is the major factor affecting the pace of overall activity. In our forecast, inventory investment ceases to influence GNP growth significantly from now on as business stocks are kept about in line with sales. We presume that high interest rates and improved control methods will hold stocks at historically lean levels. The overall expansion, however, does receive some support from increased real government purchases (particularly defense outlays) and from improved net exports, which become a moderately positive force as the dollar declines.

Among the components of final purchases, the strength of business fixed investment has been a major surprise--the next chart. We estimate that real business fixed investment increased at about a 20 percent annual rate in the second quarter after a 16 percent annual rate rise in the first. As shown in the upper left-hand panel, new orders for capital goods have continued to climb vigorously, increasing backlogs and pointing to further gains in spending later this year. As shown in the right-hand panel, nonresidential construction has been extremely strong as well, with large increases evident in shopping centers and other commercial structures.

A number of factors have helped stimulate the growth of capital investment; the dramatic slowing in the rise in capital equipment prices, portrayed in the middle left panel, combined with tax law changes have significantly reduced effective capital costs. The opportunities for gains in efficiency with new high-tech equipment and the spillover from the ballooning defense program have undoubtedly also stimulated spending. And of course, the improved corporate profits position (illustrated on the right) has played a role.

In an environment of continued overall expansion and reduced capacity slack, we anticipate that capital outlays will remain strong, but the pace of growth should moderate considerably from that recently. We are projecting a 7 percent increase during 1985, down from a 16 percent rise this year. Nevertheless, as pictured in the bottom panel, we anticipate that this capital expansion will be the strongest in the postwar period.

As indicated on the next chart, the growth of real consumer outlays also has been contributing substantially to the expansion of activity. Over the past three quarters, real personal consumption expenditures have risen at an impressive 6-1/2 percent annual rate. While strong gains in employment and real income have played a key role, the high level of consumer sentiment, portrayed in the right-hand panel, undoubtedly has been important, and is consistent with the continued relatively low saving rate. Looking ahead, though, some of the factors that generated earlier improvement in consumer attitudes and stimulated spending, such as the strong stock market, the tax cuts and declining interest rates are no longer providing such support, and thus, as shown in the middle panel, we expect a reduced rate of growth in consumption as gains in real disposable income taper off. Our projections are consistent with the saving rate remaining relatively low through the period.

As indicated earlier, the clearest current evidence of weakness in a major sector is in housing where activity has begun to decline in response to the rising mortgage rates. As shown in the upper left-hand panel of the next chart, this weakness is also evident in new home sales, which have dropped for three successive months. Over the past year or so, the increasing use of adjustable rate mortgages, with initial interest rates well below those on fixed rate loans, provided considerable support for growth in housing activity. As shown in the right-hand panel, recently, ARMs have comprised roughly two-thirds of all conventional home mortgages closed, more than double the percentage a year earlier. However, figures for May and June show increases in the average initial rate on ARMs closed, apparently reflecting both the higher level of interest rates generally and reductions in the size of so-called "teaser" discounts. Although there remains a significant spread between the initial rates on fixed and adjustable rate mortgages, we believe the stimulative effect of ARMs will diminish appreciably in coming months.

Consistent with some further tightening in mortgage markets over the projection period, as indicated in the bottom panel, we have projected total starts to edge down to about a 1.6 million unit rate by next spring and to stabilize at that pace in the latter half of 1985.

Job seekers have been benefitting greatly from the strength of overall activity. As indicated in the next chart, although we are projecting about the same rise in real output during this year as in 1983, we expect to generate larger gains in employment, with productivity growth slowing in a typical cyclical fashion. As the two middle panels illustrate, improving employment opportunities also are stimulating an increase in labor supply. Nevertheless, job gains have been strong enough to reduce unemployment significantly. In June the rate dropped to 7.1 percent, down from over 8 percent last December; by the fourth quarter of this year, we are projecting an unemployment rate of about 6-3/4 percent. Employment increases are expected to be less impressive next year, along with the smaller rise projected for real output, and the unemployment rate should drift down to about a 6-1/2 percent rate by year-end.

The next chart illustrates the relatively temperate behavior of wages in the face of the considerable strength in activity and employment. The hourly earnings index shows continued moderation with the overall rate of increase for production workers in nonfarm industries only slightly over 3 percent so far this year. Forces affecting different industries vary considerably--in manufacturing where wage increases have been fairly stable this year, gains continue to be damped by multi-year contracts negotiated at the depth of the recession; in construction, a substantial increase in nonunion competition appears to be playing an important role in further reducing wage growth. But overall, the continued moderate rate of wage rise suggests that labor markets on the whole still contain a reasonable degree of slack and that rising inflation expectations are not as yet exerting significant upward pressure on wage bargains.

The recent experience has led us to revise downward somewhat our view of the outlook for wage inflation. Compensation per hour, shown in the middle panel, is now increasing at about a 4-1/2 percent annual rate on a four-quarter basis, the slowest pace in nearly two decades. But we still expect that conditions later this year and in 1985 will become less favorable to wage moderation. We already have seen a drop in the number of new wage concessions, and improved sales and profits, and tighter labor markets, will surely result in firming of wages generally. Next year, we are projecting compensation costs to rise about 6 percent.

As indicated, we anticipate that productivity gains will taper off further, consistent with our continuing belief that the long-term trend is a little over 1 percent; thus we can expect less of an offset to compensation costs. Unit labor costs are projected to rise about 3-1/4 percent this year, up from less than 1 percent in 1983; in 1985 we are projecting an increase of 5-1/4 percent.

The outlook for inflation is presented in the next chart. As with wages, the recent price performance has been better than we had expected, and we now project that the rise in gross business product prices will average about 4 percent during 1984--about the same as last year. Nevertheless, increased upward pressure on prices appears highly probable by late this year and in 1985 as labor costs rise--as shown in the top panel--and as slack is reduced. Other factors will also be working to boost inflation. As indicated in the bottom panels, food prices are expected to surge again later this year as meat supplies tighten, and overall energy prices are projected to edge up in 1985 after two years of drifting down slightly on balance. But most important, with the foreign exchange value of the dollar projected to decline 15 percent from its second quarter level, prices of non-oil imports--the right panel--are expected to rise markedly. And the effects on domestic inflation will be exacerbated by reduced competitive pressures from abroad. On balance, we now expect gross business product prices to increase about 5-1/2 percent during 1985, ending about two years of inflation in the 4 percent range.

Mr. Truman will continue the presentation.

E.M. Truman
July 16, 1984

FOMC CHART SHOW PRESENTATION -- INTERNATIONAL DEVELOPMENTS

The upper panel in the first international chart shows the substantial rise in U.S. short-term interest rates during the first six months of 1984. This rise has contributed to sharp criticism of U.S. policies from the developing countries, especially those in Latin America struggling with large dollar-denominated external debts carrying floating interest rates. The other industrial countries, except for Canada and, more recently, the United Kingdom, have not allowed the rise in dollar interest rates to affect their own interest rates. As a consequence, the differential between U.S. and foreign interest rates has widened significantly.

This widening differential has been a key factor behind the continued strength of the dollar so far in 1984 -- shown in the bottom panel. However, for the reasons the staff discussed at length in its presentation in May, we believe that the growing U.S. external deficits will weigh increasingly heavily on the dollar's foreign exchange value. With most of the rise in real interest rates behind us, we are projecting a depreciation of the dollar by 15 percent on average from the quarter just ended to the fourth quarter of next year.

The top panel of the next chart shows the growth of U.S. real domestic demand and real GNP. As can be see , the ga between the two growth rates has expanded steadily, reaching 2 percent in the first quarter of this year. This gap indicates that a significant share of the U.S. demand has spilled over to stimulate economic activity in other areas of the world -- shown in the lower two panels.

With the slowing of the U.S. expansion and projected depreciation in the dollar, the direction of this net impulse will be reversed by the second half of 1985. Meanwhile, the growth of economic activity in the foreign industrial countries is projected to remain in the range of 2-1/2 to 3 percent on average, as growth in Canada and, to a lesser extent, in Japan slows under the influence of slower U.S. growth. On the other hand, economic activity in the non-OPEC developing countries is projected to pick up further, reaching almost 3-3/4 percent on average by the end of next year -- still, however, far below the average pace of 5-1/2 percent that prevailed from 1976 to 1980.

The next chart provides some perspective on developments with respect to U.S. exports, which have been adversely affected in recent years by the strength of the dollar and the resultant deterioration in our international price competitiveness. Despite such influences, U.S. exports have increased from the low point reached in the fourth quarter of 1982. Indeed, the expansion has been about average for similar periods of U.S. economic recovery.

The heavy black line in the top panel shows that the value of U.S. exports in the fourth quarter of 1982 was 20 percent below the level in the first quarter of 1981. As the red line indicates, the percentage decline in exports to developing countries -- OPEC and non-OPEC -- was even larger. In dollar terms, the total decline in U.S. exports was about $50 billion, divided almost equally between developing and developed countries.

Since the fourth quarter of 1982, U.S. exports to developing countries have continued to stagnate, while exports to developed countries have almost regained the rate reached in early 1981.

As is shown in the middle panel, most of the recovery in U.S. exports to developed countries has been in trade with Japan and Canada; in the latter case, the data are affected by exports of automotive products that later return to the United States as completed vehicles. In contrast, U.S. exports to Western Europe, indicated by the red line, have increased marginally since the third quarter of last year, but in April and May they were still 20 percent below the rate of three years ago. The weaker performance of U.S. exports to Western Europe reflects not only the sharper appreciation of the dollar against the European currencies but also the relatively sluggish growth of activity in those countries.

U.S. exports to developing countries, shown in the bottom panel, have been generally weak. Most of the decline in such exports has been in those to Latin America. In recent quarters, exports to Mexico have recovered significantly, while exports to other Latin American countries, which are generally at an earlier stage in their own adjustment programs, have stabilized at the rate of early last year.

Although the expansion of U.S. exports will continue to be held back by the adjustment efforts of developing countries and the sluggish economic activity in other industrial countries, we expect a continuing expansion, especially next year, when U.S. exports should be boosted by the depreciation of the dollar. Thus, as is shown in the top panel of the next chart, we are projecting over the four quarters of this year and the four quarters of next year an expansion in U.S. non-agricultural exports at annual rates of about 15 percent in value and 7-1/2 percent in volume.

The bottom panel shows our projection for U.S. non-oil imports. For 1984, we anticipate a modest slowing in the growth of these imports in volume and value terms from the torrid pace of 1983. Most of the projected growth, however, was recorded during the extraordinary surge in imports in the first four months of the year. Next year, with the depreciation of the dollar, the dollar price of non-oil imports should rise markedly, as Mr. Zeisel has already indicated. This should bring about a slight decline in their volume.

Despite the projected change in the relative growth rates for non-oil imports and non-agricultural exports, the U.S. trade balance is projected to continue to deteriorate. As is shown in the top two panels of the next chart, payments for total merchandise imports now exceed receipts for total merchandise exports by more than $100 billion -- a margin of almost 50 percent. If exports and imports were to grow at the same percentage rate, the trade balance would expand further in dollar terms. The value of exports must increase correspondingly more rapidly than the value of imports to close the dollar gap, and this condition will not be met during the forecast period. As a consequence, the trade balance is expected to exceed $125 billion during 1985. With the further erosion of our net international investment position, the margin of service receipts over service and transfer payments will narrow further (despite the boost to direct investment receipts from the dollar's depreciation), and the U.S. current account deficit is projected to reach almost $115 billion.

Mr. Prell will now continue our presentation.

DOMESTIC FINANCIAL MARKETS

This year's brisk GNP growth has been financed by exceptionally rapid growth in debt. As may be seen in the top panel of the next chart, domestic nonfinancial sector debt increased at around a 13 percent annual rate over the first half--well above the Committee's monitoring range. If, as indicated in the box, we strip out a rough allowance for the credit used in corporate mergers and buyouts, the debt measure still grew a little faster than nominal GNP--and at a pace rivaling the strongest of the past three decades.

The bottom panels put the financial flows in cyclical perspective. Total funds raised in markets--both debt and equity--has been plotted here, to reduce the distortion of equity absorption in debt-financed mergers.[1] As you can see in the left panel, external financing by all sectors--relative to GNP--has run consistently above what was seen during earlier cyclical upswings. This initially reflected abnormally high borrowing by the federal and state and local governments, but (as the right panel reveals) financing by the household and business sectors, together, has been heavy relative to GNP since late last year.

The next chart focuses on the household sector. The top panel shows the remarkable surge of borrowing since late 1982, in both mortgages and consumer credit. We are projecting a diminution of this borrowing over the next year and a half. This fall-off is largely a function of higher interest rates and nonfinancial demand factors--rather than a response to any current financial strains among households. As may be seen in the bottom left panel, in the aggregate the indebtedness (in red) of the household

1. Because not all share-liquidating mergers were debt-financed, this flow could understate a bit the external financing that would have occurred ex mergers.

sector has risen only slightly relative to income, while, despite the drop in the stock market, the financial asset position of the sector is still strong. The right hand panel indicates that--in an environment of rapidly rising employment--consumer installment loan repayment experience has been very favorable; mortgage loan delinquencies also have declined, but they remain relatively high and the recent aggressive marketing of ARMs of course raises some questions about the prospects for further declines.

In the business sector, covered by the next chart, the rise in borrowing this year has reflected more than just the financing of mergers and buyouts. As the upper panel indicates, nonfinancial corporations as a group have experienced a swing from net financial surplus a year ago to a net deficit --and our forecasts of investment and profits point to a growing financing gap through 1985. The bottom left panel portrays the composition of external financing activity by corporations. In the first half of this year, borrowing rose sharply, primarily to offset an unprecedented net absorption of equity in mergers but also to make up for a reduction in new equity issues prompted by falling share prices. Owing to the weakness of the bond markets--as well as the greater ease of raising funds initially from short-term sources for major mergers--the bulk of corporate borrowing in the first half occurred at banks and finance companies and in the commercial paper market. The result of all this was an unusually early end to the normal cyclical reliquification of corporate balance sheets. The heavy load of short-term and variable-rate debt exposes businesses to renewed cash flow pressures from rising interest rates. Nonetheless, as the right panel shows, we are projecting that, with interest rates remaining at high levels, short-term debt is likely to continue rising in relative importance.

The pattern of credit flows in the months ahead could be affected by the tensions apparent in the financial system. Concerns about the strength of commercial banks has, as may be seen in the next chart, resulted in higher rates on bank CDs and other liabilities and bank stock prices have fallen markedly, making equity capital more costly for these institutions. Such developments would be expected to hamper banks in their roles as financial intermediaries, but while bank credit growth slowed markedly in June and bank officers report a tightening of lending policies, we really do not yet have any clear indication of the macro-impact of the bank problems. Similarly, the activities of thrift institutions--whose lending has buoyed the housing market--could be affected by financial stresses in that industry. Rising interest rates since mid-1983 have been reflected in falling S&L share prices. S&L earnings have been slightly on the plus side, but a deterioration in industry operating results over the remainder of the year is implied by the staff's interest rate projection. A very sizable proportion of institutions will be in the red, and failures could multiply--possibly causing investors to shy away from S&L liabilities.

Mr. Kichline now will conclude the presentation.

JLKichline
July 16, 1984

FOMC CHART SHOW -- CONCLUSION

The last two charts in the package present economic projections of Board members, Presidents, and the staff; the first chart displays the information on the basis of changes measured fourth quarter to fourth quarter. For 1984, there aren't any particularly significant differences in the forecasts. Compared with the forecasts reported to the Congress in February, which are shown in the bottom panel, nominal GNP projected currently is at the top or above the central tendency. However, real growth is now expected to be appreciably stronger while prices are projected to rise less than previously forecasted.

The projections for 1985 generally point to slowing in growth of nominal and real GNP and some acceleration in the pace of inflation. The Administration's figures do not appear on the table, but it is our understanding that the projections to be used in the budget update essentially adjust to the developments in the first half of the year and maintain the previous forecasts of the period ahead. That approach provides numbers close to those of Board members and Presidents for 1984. For 1985, the Administration has forecasts of nominal GNP around 9 percent, with real growth of GNP at 4 percent--on the high side--and a deflator rising at 4-3/4 percent--on the low side of the Federal Reserve expectations.

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